KENTUCKY PUBLIC PENSION WORKING GROUP

DEFINED CONTRIBUTION SUBCOMMITTEE

ACTUARIAL CONSULTING ANALYSIS

October 2008

Personal Background

- Fellow of Society of Actuaries and Enrolled Actuary
- over thirty years of pension plan consulting, primarily with corporate plans
- extensive experience with defined contribution conversions and administration
- worked with legislature and administration on pension reform

Areas to Be Covered

- the design challenge
- the operational challenge
- what has been done so far?
  - House Bill 1
  - other significant 2008 bills
- retirement benefit philosophy
  - benefit adequacy
  - defined benefit vs. defined contribution focus
- possible DC plans
- summary

Number One Design Challenge

- Inviolable Contract -- Essentially No Changes in Pension Benefits for Existing Participants
- Exception is annual COLA (cost-of-living) increases for retirees
- AS A RESULT, CHANGES IN PLAN DESIGN AND PLAN STRUCTURE CANNOT REDUCE THE UNFUNDED ACTUARIAL LIABILITY (UAL) OR FUTURE ACCRUALS FOR EXISTING EMPLOYEES

Number One Operational Challenge

- Meet the Funding Schedule in HB 1
  - significant annual cost increases
  - 100% of ARC by 2025
  - KERS-non now at 35%
- UAL is Only Reduced by:
  - FUNDING the Actuarially Required Contribution
  - Favorable Actuarial Experience/Assumptions

What Did HB 1 Accomplish? -- Amount of Pension

- For New Employees
  - Extended Requirements for Unreduced Retirement
  - Increased Requirements for Early Retirement
  - Reduced Benefit Accrual Factors at Full Retirement
  - Graded Benefit Accrual Factors prior to Full Retirement
  - Tightened Definition of Final Average Earnings
- For All Participants
  - Reduced COLA to 1.5%
  - But does not pre-fund COLA

What did HB 1 Accomplish? -- Annual Cost for New Employees

		Employer Normal Cost – Pension Only		
	Employee	Prior to HB 1	After HB 1	Annual Payroll
KERS-Non	5.00%	2.97%	1.11%	$1,780,223,493
KERS-Haz	8.00%	6.31%	3.27%	$ 144,838,020
CERS-Non	5.00%	3.12%	1.21%	$2,076,848,328
CERS-Haz	8.00%	7.38%	4.66%	$ 459,998,956
SPRS	8.00%	8.97%	5.05%	$ 49,247,580

Note: For the non-hazardous groups, a new employee is paying over 80% of the pension cost. Typical corporate 401(k) match is 50% of the first 6% deferred.

Comparison of KERS Non-Hazardous Costs

	Annual Pension Cost for New Employees	
	Normal Cost	Primary Difference from HB 1
House Bill 1	1.11%	
Revised Senate Proposal	1.65%	Employee Choice: Matched 1% DC or Full DB after 5 yrs.
Original Senate Proposal	2.40%	1% of Ee Contribution to a Matched DC Account
Original House Proposal	1.31%	Rule of 85 for Unreduced Retirement
Prior to House Bill 1	2.97%	

Benefit Adequacy

- As a general rule, retirement industry professionals believe that the employer's retirement system plus Social Security should provide a replacement ratio of 70-90% of pre-retirement income.
- These are two of the components of the "Three Legged Stool" of retirement income. The third leg is personal savings.
- Under HB 1, a thirty year retiree's replacement ratio will be:

Pension	52.5%
Social Security	30.0%
Total	82.5%

- Since many participants retire from KRS before age 65, they may not be eligible for Social Security immediately and would have a lower ratio initially. However, this will be partially offset by the value of retiree medical coverage.
- By comparison, a thirty year KTRS participant will retire with 75% of FAC from the system. Teachers generally do not participate in Social Security, but do have retiree health coverage.

What Is The Focus? -- Defined Benefit

- What will you have at retirement?
- It will pay monthly for as long as you (and your spouse) will live
- Benefit Security

What Is The Focus? -- 401(k)

- the benefit of long term savings with compound interest
- tax advantages
- employer will match your savings - Free Money!!
- understandable: you know what you have
- choice: manage and move your investments
- access: loans, hardship withdrawals, portability
- lump sum payouts

What Does This Tell You?

- Defined Benefit is a retirement vehicle for long term employee
- 401(k) is a savings vehicle
  - the third leg of the retirement stool
  - added to Internal Revenue Code to reward savings
  - marketed by Fidelity (and others) to sell mutual funds
  - popular with employers
    - reduce employer cost; transfer to employee
    - avoid complex IRS and FASB rules

Why Offer A *Matched* 401(k)?

- Savings is good; rewarding savings is good
- Kentucky Deferred Comp is Popular;
  - over 30% of state employees now defer (with no match)
- People will save more if matched
  - Ky. School Districts with match average 72% participation
  - Corporate Experience is 70-90%
- Can offer sizzle

What Would A Match Cost?

- Assume a voluntary 401(k) for new employees only
- Matched 50% up to 2% of pay (employer cost is 1%)
- With 60% participation, first year cost is $900,000
- Year five cost is $3,300,000
- Cost continues to grow annually
- Total KERS-non payroll is $1.8 billion (1% = $18 million)
- Can reduce cost with design features
  - one year eligibility
  - 3-5 year vesting
  - dollar match maximum, *e.g.* $300

Another DC Design--Appointee Accumulation Plan

- restricted to non-merit employees earning $50,000 per year
- people who serve in significant positions, but
  are only expected to work in government for a few years
- participants contribute 5% of pay with 20% match
- employer makes remainder of full contribution to KERS
- cost is 1.0% of covered payroll, approx. $800,000 per year
- cost of match is less, if participation is voluntary
- cost doesn’t grow significantly over time

The KRS Funding Challenge

- HB 1 requires full ARC to KERS-non by 2025
- projected to exceed 40% of payroll by that date
- current budget is 10.01% for FY 2009 and 11.61% for FY 2010
- earlier ARC funding required for KERS-Haz and SPRS
- challenge is compounded by COLA that is not pre-funded

Summary

- Inviolable Contract restricts design
- Funding Schedule dominates operation
  - Scheduled underfunding increases ARC annually
  - Unfunded COLA will also increase ARC annually
- HB 1 reduces cost for future employees
  - lower annual cost than other proposals
  - produces adequate retirement income
- DB is a retirement system; DC a savings system
- Matched 401(k) has real merit, but real cost